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Snowbirds and U.S. taxes

Understand how you are impacted and act accordingly

TD Economics reports that more than 500,000 Canadians spend significant periods of time in the United States. These individuals may be unaware that a Canadian can be deemed a U.S. person and subject to U.S. tax filing requirements if holding certain investment vehicles.

The definition of a U.S. person is quite broad. It generally includes U.S. citizens and residents, U.S. green card holders, anyone with a substantial connection to the U.S. and certain entities organized in the U.S. The Internal Revenue Service (IRS) says anyone deemed to be a U.S. person holding certain investment vehicles is subject to Passive Foreign Investment Company (PFIC) rules.

A PFIC is a non-U.S. corporation that has either 75% or more of its gross income consisting of passive income or 50% or more of the fair market value of its assets consisting of assets that produce passive income. According to an IRS directive, this means the majority of Canadian mutual funds and exchange-traded funds (ETFs) are PFICs. In some instances, certain public companies such as REITs are considered to be PFICs.

PwC notes that PFIC rules are designed to prevent taxpayers from deferring tax on passive income earned through foreign corporations or converting this income into capital gains taxed at preferential rates. There is much debate whether Canadian funds belong in that category.

The Investment Funds Institute of Canada (IFIC) argues there is sufficient similarity between the tax treatment of mutual funds in Canada and the U.S. to support the exclusion of Canadian mutual funds from the PFIC rules. They have made a submission to U.S. congress to exclude Canadian mutual funds from PFIC rules; however, there is yet to be any change.

U.S. persons who hold PFICs have three options regarding taxation. The default taxation method (Excess Distribution) is the most onerous. Generally speaking, gains and distributions are fully taxed as income. Also, amounts allocated to the previous three years are subject to U.S. tax at the highest marginal rate and subject to deemed interest charges.

However, there are two alternative elections that U.S. persons can make. One is the Mark-to-Market election, which requires investors to report all distributions as ordinary income and recognize all increases/decreases to the value of the investment as a gain/loss on their holdings, even if they were not disposed of.

The preferred election for most investors is the Qualified Electing Fund (QEF), which requires investors to report their pro-rata share of the fund's earned income and capital gains for U.S. tax purposes. This means that distributions or

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gains from sale would be taxed in a similar fashion to how mutual funds in the U.S. are normally taxed.

Some mutual fund companies are supplying tax-reporting information to help U.S. persons make the QEF election, and investors should ask their fund companies for the necessary data. For example, Fidelity Investments provides a PFIC Annual Information Statement. On the ETF front, Purpose Investments is also helping investors comply with PFIC rules.

PFIC filing rules are exceedingly complex and non-compliance can bring costly consequences. Investors should seek advice from a qualified U.S. tax expert.

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